IN THE

Supreme Court of the United States

OCTOBER TERM, 1945

No. 197.

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

ANNA VICKERS CRAWFORD,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

SUPPLEMENTAL BRIEF FOR RESPONDENT.

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Prefatory Statement.

Because of time limitations, Respondent's brief was printed and mailed for filing before the receipt of Petitioner's brief. Petitioner's brief incorporates by reference the argument of the Commissioner in his brief in *Kirby Petroleum Co. v. Commissioner*, No. 56 this Term. All references herein are to the Commissioner's brief filed in *Kirby Petroleum Co. v. Commissioner*.

Supplemental Argument.

The Commissioner in his brief argues that as a matter of basic principle a net profit participation in the results of the operating interest can never constitute a royalty (Br. 6-14).

The Commissioner first summarily disposes of the basic point at issue by a flat statement that it makes no difference whether a lease or a sale is involved (Br. 10). The Commissioner offers no direct authority for this sweeping statement. There is none. This is a primary issue in this case. See Respondent's main brief, pages 20-22. And as will be developed more fully herein, this difference between a lease and a sale is the decisive factor in this case.

After assuming this point at issue, the Commissioner argues that a depletable interest cannot exist unless it has a direct relationship to production (Br. 12). It simply does not follow that a share in the net profits of production retained by a lessor cannot constitute a royalty. Production necessarily precedes net profits from operation and if the lessor does receive a portion of the net profits of the operating interest, by hypothesis, there has been production. The mere fact that there may be production with no net profits does not imply that the fee owner has parted with any portion of his economic interest in the oil in place or that what he does receive is not a royalty. The fact that he is willing to take a chance on the net economic results of the exploitation of his economic interest does not mean that he has parted with such interest. He may receive little or nothing. On the other hand, he may receive a great deal; but whatever he does receive is solely the result of production of oil from his land. This argument of the Commissioner has no bearing one

way or the other upon the determination of the issue involved.

The Commissioner further argues that the rule of apportionment of the deduction for depletion between lessor and lessee necessarily precludes depletion in the case of a net profit participation. Taxpayer fails to see the significance of this argument. The necessity for apportionment is conceded. The formula therefor was laid down by this Court in *Helvering v. Twin Bell Syndicate*, 293 U. S. 312, and this formula operates as effectively in the case of net profit participation royalties as in any other type of royalty. The question in the *Twin Bell Syndicate* case was the determination of the amount of gross income from the property to the working interest. This Court held that gross income from the property to the working interest subject to depletion "means gross income from production less the amounts which the taxpayer was obligated to pay as royalties." The Commissioner argues at page 13 of his brief that it follows from this case that the depletion allowance must be apportioned in accordance with the respective interests of the parties in the gross production of the oil or the gross income therefrom. Here again the Commissioner is lifting himself up by his bootstraps. If the net profit participation of the fee owner-lessor constitutes a royalty, the gross income to the working interest subject to depletion means gross income less amounts he has to pay to the lessor by way of the lessor's net profit participation. Clearly the *Twin Bell Syndicate* case does not support the Commissioner's assertive statements that a lessor must participate in gross production in order to have a depletable interest.

The Commissioner relies in part upon *Anderson v. Helvering*, 310 U. S. 404, to support his statements that

only a participation in gross production constitutes a royalty. It must be remembered that the *Anderson* case involved an outright conveyance or sale of an economic interest in the land. In such circumstances, if an interest in gross production by way of an oil payment is retained, the vendor has a royalty because he has an assurance of participation in production. In cases involving a sale, the owner of an economic interest purports to part with his entire ownership. However, this Court has held that if the owner retains an interest in gross production by way of an oil payment, he has reserved from his sale a depletable economic interest, but if the specific sum to be paid may be paid by the vendee out of sources other than the oil, the vendor has not reserved an interest which can be characterized as an oil payment or royalty subject to depletion. *Anderson v. Helvering, supra.*

The *Anderson* case should not be extended beyond its facts. When there is a sale or a conveyance by which the owner or lessee has effectively parted with his entire legal interest, it is necessary to look to the method of payment by the vendee to determine whether the vendor has retained an economic interest in the oil. An interest in gross production in such case, *i. e.*, a traditional royalty or oil payment, represents an economic interest in the oil in place, whereas a participation in the vendee's net profits does not. *Anderson v. Helvering, supra; Helvering v. Elbe Oil Land Development Co.*, 303 U. S. 372. But these principles are not applicable to leases by the fee owner. The reversionary interest of the fee owner of itself constitutes an economic interest in the oil.

The Commissioner places too much reliance on *Palmer v. Bender*, 287 U. S. 551. In that case, the lessee of certain oil properties assigned his interest in considera-

tion of a cash bonus, an oil payment and a gross royalty. The lessee claimed depletion on all payments received from his assignee. The Commissioner argued that the assignment under state law constituted an outright sale leaving no reversionary interest in the assignor. Consequently the payments received by the lessee were not royalties subject to depletion but were taxable as capital gain. In this case, the Commissioner conceded "that, if any reversionary interest, according to the common law, however small, has been retained in the leased land by the two partnerships, the petitioner is entitled to the depletion allowances claimed." 287 U. S. at 553.

This Court held that in the case of a complete assignment of this nature, it was immaterial whether the form of the document constituted an assignment or a sublease according to state law; that the formal attributes of the instruments or the descriptive terminology which may be applied to them *according to the local state law* are irrelevant. The holding of this case is not that the form of legal relationship created must in every instance be disregarded. Its essence is that although the parties may have effected a sale as a matter of form, if the vendor has retained an interest in gross production of the vendee, he has carved out of the rights sold and retained an economic interest in the oil in place.

It is vitally significant that in all the cases relied upon by the Commissioner, the question presented has been whether or not in the case of a sale the payment involved represented a royalty subject to depletion. In such cases the nature of the payment is determinative. A lease by the fee owner which cannot possibly be construed as a sale presents an entirely different situation. *Burnet v. Harmel*, 287 U. S. 103 is wholly in point. This case

involved the execution of an oil lease by the owner in fee of Texas oil lands in consideration of a bonus and a royalty measured by the gross production of oil. The taxpayer took the position that under Texas law the leases constituted a present sale of the oil in place, and treated the payments received from the lessee as gain from the sale of a capital asset. This Court held that the lease conformed to the usual type of oil lease and that it was immaterial that under the law of Texas title to the oil in place passed to the lessee. The economic consequences of the lease were that the lessee acquired the right to enter upon and use the land for the purpose of exploiting the oil and gas and that all oil and gas not extracted remained the property of the lessor upon the termination of the lease. Such a transaction does not constitute a sale or conversion of a capital asset. Accordingly, it was held that what the lessor received was a royalty.

Thus it is perfectly proper to conclude that in the event of the execution by the fee owner of an oil document which purports to be an absolute sale of his entire interest, it is necessary to look to the method of payment by the vendee to determine whether an economic interest in the oil has been retained by the vendor; whereas, in the case of an execution by the fee owner of a typical oil lease, the legal consequences of the form of the lease and the method of payment by the lessee (gross or net results of drilling) are immaterial because the lessor by virtue of his reversionary interest, if nothing else, retains an economic interest in the oil in place.

The Commissioner states that Treasury Regulations support his position (Br. 19, 25). Examination of the pertinent provisions of Treasury Regulations 103, namely

Section 19.23 (m)-1, as quoted on page 19 of Commissioner's brief, clearly refutes the Commissioner's position. These Regulations merely incorporate the principle of *Helvering v. Bankline Oil Co.*, 303 U. S. 362, to the effect that an agreement between the *owner* of an economic interest and *another* entitling the latter to share in the net income derived from the interest of such *owner* does not convey a depletable economic interest. Here the taxpayer is the owner. She is not acquiring from another owner an interest in net profits, but has granted another person the right to exploit her economic interest in consideration of a share of the net profits of the exploiter. The *Bankline Oil Co.* case (Resp. Main Brief 11, 21) has no bearing on the factual situation presented in the instant case. Treasury Regulations do not support the Commissioner. In fact, the Commissioner has been treating the net profit participation of the taxpayer as a royalty subject to depletion for years and it was not until after the issuance in 1941 of G. C. M. 22730, 1941-1 C. B. 214, that the Commissioner began to take the position that a lessor's participation in net profits of the lessee could not constitute a royalty.

The Commissioner has attempted to support his position that the net profit participation can be fully taxed as ordinary income with no allowance for depletion (Br. 25-28) with the vague statement that so far as the lessor is concerned, the payment has all the attributes of ordinary income. What are "the attributes of ordinary income"? This question depends upon the relationship of the parties and the reason for the payment. In *Schermerhorn Oil Corp. v. Commissioner*, 46 B. T. A. 151 (Br. 26) the net profit payments were held to be ordinary income to the payee because he was an employee of the operating oil

company. The payments were deemed to be additional compensation for services rendered. In *Burnet v. Harmel, supra* (Br. 26), the payments were income to the lessor, *but the lessor was allowed depletion thereon.* In *Sunray Oil Co. v. Commissioner*, 147 F. (2d) 962 (C. C. A. 10th), cert. den. May 21, 1945, the payment made by the oil company was a bonus which, while a capital investment by the oil company deductible in computing its gross income from the property, was income to the recipient, *but the recipient was entitled to take depletion against the bonus.*

There is no question here but that the payments received by the lessor are income. The only question is, are they royalty income or some other type of income? The Commissioner, after arguing that the payments are not royalty income, states "because of its continuing interest in production by way of oil royalties, the lessor has not made a sale of any capital asset" (Br. 26).[1] The Commissioner thus focuses the crucial issue in this case. Why are the payments made to the lessor income? Obviously, if they are made for the sale of a capital asset, the excess amount received over cost would be capital gain income. If they are not received as consideration for the sale of an asset, they must be consideration for the execution of the lease. In such case, they constitute consideration paid by the lessee for the right to extract and sell oil, a recompense to the owner for the exhaustion of the oil in place; in other

[1] *Cf.* Commissioner's brief, page 23, wherein the argument indicates that if the payments do not represent a royalty, they are "regarded as proceeds from the interest sold." The cases cited by the Commissioner on page 23 held that the payments not considered as royalties should be treated as capital gain resulting from the sale or conversion of a capital asset.

words, a royalty or gross income from the property subject to depletion.

Consider the intolerable situation resulting from the Commissioner's argument. Assume that T owns land containing oil deposits and has a cost basis therefor of $1,000,000.00. T executes a lease with a drilling company requiring the payment of a royalty equal to one-half of the net profits from the sale of oil. For a period of twenty years thereafter, T receives as his share of the results of drilling, $500,000.00 per year or a total of $10,000,000.00. At the end of twenty years the wells go dry and the land reverts to T.

The Commissioner assumes (Br. 20) that in this situation T is not entitled to depletion.[2] He also takes the position that the taxpayer has not sold any part of his interest so as to result in capital gain. What would be the tax result? T pays taxes on $10,000,000.00, receives back his land exhausted of all oil content and still has his cost basis of $1,000,000.00 which has not been recouped by deductions for depletion, or by deduction against sales price. T's valuable asset which cost him $1,000,000.00 has been exhausted but he still holds valueless land at a cost of $1,000,000.00. This is in effect a tax on capital.

This situation cannot be permitted to exist. Either T is entitled to depletion deductions as his asset is being

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[2] *Felix Oil Co. v. Commissioner*, 144 F. (2d) 276 (C. C. A. 9th), held to the contrary. The Ninth Circuit Court relied in part on the *Felix* case in affirming the decision of the Tax Court in the instant case. The Tax Court in the instant case and in *Kirby Petroleum Co.*, 2 T. C. 1258, did not rely solely on the fact that a gross royalty had been retained by the lessor. The Commissioner has misinterpreted *Estate of Japhet*, 3 T. C. 86 (Br. 20). The *Japhet* case involved an outright sale and was decided on the basis of *Helvering v. Elbe Oil Land Development Co., supra.*

wasted or he is entitled to deduct his cost from the proceeds received and treat the excess as capital gain. To say that T in this situation merely "has contracted for and has received an economic advantage resulting from the operator's ability to earn profits" (Br. 26) is to ignore salient economic facts.

The Commissioner further confuses the issue (Br. 31-34) by assuming that depletion must be equated in terms of barrels. There is no reason why the amount of royalties subject to depletion, *i.e.*, gross income from the property, must be expressed in terms of barrels. There is no necessary relationship between advance bonuses and the number of barrels of oil extracted, yet advance bonuses are subject to depletion. Viewed from this advantage, the complex problem presented by the Commissioner (Br. 31-34) vanishes into thin air. In the Commissioner's example the total royalties of the lessor are $61,500.00 and not so many barrels of oil. The gross income of the lessee is $345,000.00 which need not be phrased in terms of barrels of oil. The lessee would report as gross income from the property the sum of $345,000.00 less the royalties he is required to pay to the lessor of $61,500.00. The lessee would report $283,500.00; the lessor $61,500.00. No sum whatsoever disappears from the total gross income of the property which must be reported for tax purposes. Thus the dilemma posed by the Commissioner (Br. 33) becomes illusory. The question here is not how many barrels was the lessor entitled to receive from the lessee, but what is the true nature of the payment made by the lessee to the lessor.

The Commissioner contends for the rule that a royalty must mean a share in gross production. (Br. 37.) There is nothing to commend this proposition except simplicity.

Certainly there is no valid reason which can be advanced why a royalty must always be defined in terms of gross production. So long as the proceeds received by the land owner pursuant to a lease flow from and are the results of production alone, they constitute a royalty subject to depletion. The law should not be warped to the rigid confines of a rule which results in economic distortion of fact merely because the rule is simple and easy to apply.

Conclusion.

The judgment of the Circuit Court of Appeals should be affirmed.

Respectfully submitted,

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